12 August 2008

Mr Chris Pattas
General Manager
Network Regulation South
Australian Energy Regulator
GPO Box 520
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Dear Chris

Proposed Demand Management Incentive Scheme for Queensland and South Australia

Introduction

SP AusNet welcomes the opportunity to comment on the proposed demand management incentive scheme (DMIS) for Queensland and South Australia.

As you know, Chapter 6 of the National Electricity Rules allows the AER to develop and publish a DMIS to provide incentives for distribution network service providers (DNSPs) to implement efficient non-network alternatives or to manage the expected demand for standard control services in some other way.

In setting out the proposed scheme for DNSPs in Queensland and South Australia, the AER has noted that it is in the early stages of considering its approach to the development of a national DMIS suitable for application across the NEM. The AER also notes that consultation on the development of a national scheme has not yet commenced, and that the national scheme should take account of broader policy initiatives such as the carbon emission/trading arrangements being considered by the Australian Government.

SP AusNet would like to emphasise that it supports consideration of the wider policy objectives in the development of the national scheme. In particular, SP AusNet considers it is important that the DMIS provides tangible financial incentives to the DNSPs to develop demand management initiatives. In this regard, SP AusNet notes its general concern that the proposed DMIS for the Queensland and South Australian DNSPs is essentially an ex post cost recovery mechanism. As such, it cannot truly be described as an incentive scheme because it does not reward distribution businesses that find new, innovative and least cost ways of delivering demand management solutions.

In this submission, SP AusNet provides a number of high-level observations on the issues that will need to be addressed in the development of the national scheme. By making these

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comments on the national arrangements, SP AusNet encourages the AER to consider whether changes should be made to the proposed DMIS for the DNSPs in Queensland and South Australia so that this scheme is better aligned with the type of incentive scheme that, in our view, should ultimately be developed and applied nationally. The remainder of this submission covers the following issues:

- Competitive market issues;
- Reducing administrative burden;
- Design issues and lessons from the UK; and
- Suggested outline for an amended scheme.

Competitive market issues

SP AusNet understands that the scheme applies to DNSPs that are regulated in accordance with Chapter 6 of the NER, and implicitly that the scheme relates to the provision of "standard control services". More broadly, however, in considering the provision of demand management initiatives it is important that the regulatory framework is sufficiently flexible to allow network businesses to provide demand management initiatives and network support services on a competitive basis, where appropriate. The provision of such services would not be subject to regulation by the AER.

The key principle is that regulation should not restrict network companies from providing demand management initiatives and network support services on a competitive basis. Importantly, this principle recognises that the competitive market provides the best means of encouraging and rewarding the provision of innovative solutions.

Reducing the administrative burden

SP AusNet is concerned that the proposed DMIS for the Queensland and South Australian businesses imposes an unduly high administrative burden on the DNSPs and the AER. In addition, SP AusNet is concerned that the scheme is essentially an ex post cost recovery mechanism; as such it provides very limited incentives to the DNSPs. These observations are best illustrated by examining the steps in the proposed DMIS and the key tasks in each step:

- Step 1 - Amount of the demand management innovation allowance

  The total amount recoverable under the demand management innovation allowance within a regulatory control period will be capped at an amount that is broadly proportional to the relative size of the DNSP's annual revenue requirement in the previous regulatory control period.

- Step 2 - Access to the demand management innovation allowance

The DMIS will take the form of an annual ex ante allowance provided as a fixed amount of additional revenue at the commencement of each regulatory year of the regulatory control period.

- Step 3 - Approval of expenditure under the demand management innovation allowance

  At the end of each regulatory year of the regulatory control period, the AER will conduct an ex post assessment of expenditure incurred by the DNSP in the preceding regulatory year. As a result of this assessment, expenditure will be either approved or rejected against the criteria established in the scheme. The total amount of expenditure approved by the AER over the five year regulatory control period will not exceed the total amount of the allowance determined in step 1.

  The approval criteria include:

  - demand management projects or programs claimed under the scheme should be innovative, and target broad-based and/or peak demand reductions;
  - recoverable projects and programs may be tariff or non-tariff based;
  - costs recovered under the scheme must not be recoverable under any other jurisdictional incentive scheme;
  - costs recovered under the scheme must not be recovered under any other state or Commonwealth government scheme; and
  - costs recovered under the scheme must not be recovered under forecast capital or operating expenditure approved in a distribution determination, or under any other incentive scheme in that determination

  Applications for ex post approval of expenditure under the demand management innovation allowance will be assessed annually at the time of the DNSP's service target performance incentive scheme review. The DNSP must provide an annual report to the AER including an overview of each demand management project or program for which ex post approval is sought, setting out the features of the program, and demonstrating compliance with the criteria listed above, with reference to:

  - the aims of the demand management project or program;
  - the implementation of the project or program;
  - the implementation costs of the project or program, including a demonstration that the costs incurred represent prudent and efficient expenditure; and
  - benefits arising from the project or program.

  The DNSP is also required to submit a statement certifying that the costs of the demand management program have not been recovered under another element of the distribution determination, including under another scheme applied under that determination, or any other jurisdictional incentive scheme or state or Commonwealth scheme.

At the completion of the annual review, the AER will publish the amount of any approved expenditure, and its reasons for approving, or not approving expenditure under the demand management innovation allowance. The AER will also indicate the amount of allowance remaining (in nominal terms) for the regulatory control period, which will enable DNSPs and other interested parties to observe progress under the scheme as the regulatory control period progresses.

- Step 4 - Final year adjustment

  Once data becomes available for the final year of the regulatory control period, the AER will calculate a total carryover amount on the basis of the annual assessments in step 3 to account for:

  - any amount of allowance unspent or not approved over the regulatory control period; and

  - the time value of money accrued / lost as a result of the expenditure profile selected by the DNSP.

It is clear from the above description that DNSPs are likely to incur significant costs in complying with the DMIS. It is also apparent that DBs are exposed to an asymmetric risk in terms of their ability to recover the costs of undertaking demand management initiatives. In particular, this asymmetry arises because, at best, the AER will allow 100% cost recovery and may in some instances allow substantially less. In these circumstances, commercially-orientated DNSPs would not be encouraged by the proposed DMIS to pursue demand management initiatives.

Design issues and lessons from the UK

In SP AusNet's view, DNSPs should have a regulatory incentive that encourages efficient provision of demand management initiatives. However, because these investment decisions are complex it is very difficult to devise an incentive mechanism that provides incentives to the network companies to 'do the right thing' in every conceivable set of circumstances.

However, SP AusNet does note overseas examples highlighting the innovative ways that commercial incentives could be introduced to properly encourage particular types of behaviours or investments. In this regard, it is noted that the electricity and gas market regulator in the UK, Ofgem, has introduced an incentive mechanism that remunerates electricity distribution companies for each kW of new connection capacity provided to distributed generators. SP AusNet does not necessarily advocate the adoption of this approach by the AER, but wishes to draw attention to the innovative approach adopted.

SP AusNet would encourage the AER to examine broadly the types of arrangements that have been developed in other countries to encourage demand-side initiatives. This further analysis would inform the AER's approach to a national scheme.

Developing a more appropriate scheme

SP AusNet believes that a more appropriate DMIS could be developed that would have stronger incentive properties, whilst reducing the administrative burden on the AER and DNSPs. In SP AusNet's view, the design of such a scheme would include the following features:

1. The National Electricity Rules should explicitly state that a network company should be able to undertake demand side initiatives and provide network support services on a competitive basis. The details of which (if any) services can currently be provided on a competitive basis would need to be worked through.

2. Consideration of a $/kW revenue allowance to the distribution business for each kW of load relieved from the network, with, as in the UK, an allowance for new connection capacity provided to distributed generators. SP AusNet has not yet estimated the proposed allowance, but based on the UK approach it would be reasonable to expect an allowance of approximately $4/kW.

3. Network companies should be able to propose additional incentive mechanisms aimed at encouraging the efficient provision of demand side initiatives and network support services.

4. A network business should be able to recover the costs of demand management initiatives (including R&D) and network support services that were not included in its forecast expenditure for the current regulatory period, providing that:

   (i) An approved business case for the relevant expenditure, including a forecast of the expenditure, is made available to the AER; and

   (ii) The network company provides an audit opinion to the AER stating that the amount of expenditure claimed is reasonable and accords with the approved business case.

SP AusNet notes that point 4 above would substantially reduce the administrative burden that arises from the AER's proposed scheme, without any material detriment to customers.
SP AusNet welcomes the opportunity to make this submission to the AER, and we would be pleased to discuss this submission in further detail with you at your convenience.

Yours sincerely,

Kelvin Gebert

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MANAGER REGULATORY STRATEGY AND COMPLIANCE